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SUBJECT: SALVADORAN ECONOMY GROWING, BUT STRUCTURAL PROBLEMS
REMAIN

REF: A. SAN SALVADOR 1719, B. SAN SALVADOR 0353, C. SAN SALVADOR

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Summary

¶1. Despite adherence to Washington-consensus policy recommendations, economic growth in El Salvador has been an unimpressive 2.5 percent over the last decade. The economy is picking up, however, with Central Bank data showing 3.2 percent growth for the first quarter of 2006 and forecasted 3.5 percent for the year. While natural disasters and weak rule of law are no doubt partly responsible for this poor economic performance, structural problems that limit El Salvador's export competitiveness may also be to blame for slow growth. End summary.

Economic Growth Picking Up

¶2. After a decade of GDP growth that averaged 2.5 percent, barely keeping up with population increases, the Salvadoran economy is showing signs of life again, registering 2.8 percent GDP growth in 2005 and 3.2 percent for the first quarter of 2006. The Central Bank estimated GDP growth for 2006 to average 3.5 percent for 2006; the bank's index of economic activity suggests that growth may be even higher.

¶3. FUSADES, a well-known Salvadoran think tank, agrees with the Central Bank estimate and is also forecasting 3.5 percent growth. In its most recent economic survey, FUSADES reported that sales were up for most business during the first quarter of 2006 and business confidence is high. The firms surveyed were optimistic about the investment climate, identifying CAFTA-DR as the primary factor behind this positive outlook, and most said they would expand their businesses this year. The number of participants in the Social Security health care system is another good indicator of positive economic trends in El Salvador--an increase suggests growth in formal sector employment. From February 2005 to February 2006 the rolls increased by 3.9 percent, from 492,140 formal-sector jobs to 511,504 jobs.

¶4. Growth so far in 2006 has been spread evenly among most sectors, with the construction and transportation sectors expanding most, showing 5.8 percent and 5.2 percent, respectively, according to the Central Bank. Growth in the construction sector, which averaged 3.4 percent in 2006, is boosted by housing development and large infrastructure projects such as the port being built in La Union. Meanwhile, transportation services grew in large part due to increased business at the container port of Acajutla but also thanks to an overall up-tick in economic activity.

¶5. Real estate and services, aggregated in Central Bank data, showed 4.6 percent growth in the first quarter of 2006 while

financial services grew 4.8 percent. Despite dollarization, increases in international interest rates have not been completely transmitted to local interest rates. The rate for loans up to a year increased from 6.95 in March of 2005 to 7.4 percent in March of 2006, only a 0.5 percent increase. Local interest rates remain low, thanks to excess liquidity caused by low local credit demand and strong competition among local and nonresident banks. Meanwhile, Salvadoran banks continue to grow regionally and in the United States.

¶6. Agriculture, which grew by 5.8 percent in 2005 despite flooding caused by Hurricane Stan, posted 3.8 percent growth in the first quarter of 2006. Favorable international prices for coffee and sugar, as well as new investments in poultry and cattle, contributed to these positive results. Also important was the expansion of fruit and vegetable cultivation for domestic consumption, an investment supported by USAID. Growth in the sector for 2006 is forecast at 6 percent, with the expectation that coffee and sugar prices will continue to increase and cotton cultivation will rebound from crop damages caused by Hurricane Stan in 2005.

¶7. Among the few sectors that lagged behind was manufacturing, which grew by only 1.5 percent in the first quarter, reflecting losses in the apparel (maquila) sector but growth in other light manufacturing. For the maquila sector, staggered CAFTA implementation, with El Salvador coming on board with the United States March 1, and Honduras and Nicaragua a month later, proved to be a mixed blessing. Salvadoran assembly operations saw their inputs from the latter two countries suddenly ineligible under CAFTA-DR rules of origin. Many firms shifted production to Honduras and Nicaragua and stockpiled inputs from the United States. There were as many as 4,000 job losses in March 2006, and garment exports contracted by 10 percent during the first quarter of 2006. Contacts in the sector report that operations have recovered, and firms continue to focus on full-package production, a business model that has proven successful so far in competing with China and other

low-cost producers.

Inflation Stable Despite Oil Price Increases

¶8. Despite increasing oil prices, inflation remains stable, at about 3.8 percent (annualized) for the first three months of 2006. Inflation for 2005 was only 4.3 percent, the lowest in the region. Price increases have hit the transportation sector hardest, and bus fares were recently increased to reflect higher operating costs. The Salvadoran Transportation Association now estimates that fuel costs are 60 percent of operating costs for truck owners. Thermal plants generate about 50 percent of El Salvador's electricity, and high oil prices have prompted the government regulator to allow distributors to raise rates by 14 percent. Meanwhile, generators and distributors are working with the government to implement regulations for purchasing power through long-term contracts, as well as selling power on the wholesale market using a cost-based model, to help stabilize energy costs and encourage new investment.

Comment

¶9. After the civil war, El Salvador aggressively launched a Washington-consensus economic model that included trade liberalization, cuts in government spending, privatizations, pension reform, and dollarization. While some Salvadorans are quickly taking advantage of CAFTA-DR business opportunities (Ref. A), President Saca has launched several other initiatives to kick start economic growth. However, these efforts do not stray far from the laissez-fare course set by his ARENA predecessors.

¶10. Focusing on converting El Salvador into a logistics and transportation hub for Central America, the government is strengthening the Customs Administration's role as a trade facilitator rather that revenue collector. There has also been progress in improving the country's trade infrastructure both at seaports and at the airport. To promote tourism, a new Tourism Law established tax incentives for investment in tourism infrastructure (Ref. C). Meanwhile, industrial policy has focused on improving competitiveness by streamlining the role of government and reducing transaction costs in addition to direct subsidies to promote the use

of cutting-edge technology in industrial processes. Initiatives to promote further growth in the financial sector, although delayed, have focused on streamlining the supervision of financial conglomerates and establishing improved legal frameworks for securitization, venture capital, or leasing.

¶11. Over the last decade, however, real economic growth has averaged only 2.5 percent, barely enough to keep up with population growth. Over the last five years, foreign investment has averaged only 1.5 percent of GDP. Meanwhile, the trade gap continues to grow and for the first half of 2006 was $1.9 billion, up from $1.6 billion the year before. There is no doubt that the back-to-back earthquakes in 2001, a fall in world prices for coffee and sugar, and an increase in violent crime have had a significant impact on growth here, but many Salvadorans are concerned it is the economic model--now pursued by four consecutive ARENA governments-- that is flawed. That the economy grew by 3.5 percent is good news, but there is still plenty of room for improvement.

¶12. Restoring the rule of law to stem violent crime remains a prerequisite to getting the Salvadoran economy growing at its potential (Reftel. B). However, there are two long-term issues may have throttled growth over the last decade, and may continue to have an impact for years to come. One is that the underlying structure of the economy is still uncompetitive and businesses are unprepared to take advantage of the benefits of trade liberalization. A handful of families continue to dominate the economy, especially in certain sectors: in 2002 the UNDP estimated that the richest 20 percent of El Salvador controlled nearly 60 percent of the country's economy. According to this explanation, economic concentration has led to a loss of competitiveness, and local businesses find themselves unable to either sell their products successfully overseas or compete with imports. The new Competition Superintendency, created in January 2006, could have a strong role in promoting competition among local businesses. However, early indications are that the Superintendency will avoid confrontation with the economic elite and instead focus on sectors dominated by foreigners. CAFTA-DR, and the pressure of competition from U.S. goods, also has the potential to improve local competitiveness.

¶13. The second explanation suggests that remittances, which reached 2.8 billion in 2005 and will likely exceed $3 billion in 2006, are undermining El Salvador's export competitiveness. From 1992 to 2001 (the last time it was calculated), El Salvador's real effective exchange rate appreciated 48 percent--since then, it has undoubtedly further appreciated. This appreciation has made local goods

expensive overseas and made imported goods cheaper, undermining El Salvador's trade-focused growth strategy just as the. Mitigating this remittance-fueled worsening of El Salvador's terms of trade will be difficult. Encouraging the use of remittances for investment instead of consumption, a task on which the Salvadoran Government and private sector are focused, would alleviate pressure on the terms of trade and help create jobs at home for potential migrants. End comment.

Butler